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In the Supreme Court of the United States

October Term, 1961

[redacted], petitioner

v.

[redacted], et al.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE [redacted] CIRCUIT

BRIEF FOR THE [redacted] AS AMICUS CURIAE

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In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 87

MANAGED FUNDS, INC., PETITIONER

v.

J. JOHN BROUK, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

OPINION BELOW

The opinion of the court of appeals (R. 40–71) is reported at 286 F. 2d 901.

JURISDICTION

The judgment of the court of appeals was entered on January 13, 1961 (R. 72). A petition for rehearing was denied on March 6, 1961 (R. 73). The petition for a writ of certiorari was filed on May 6, 1961 and was granted on June 19, 1961 (R. 74; 366 U.S. 958). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether an investment company can maintain an action against its directors based upon their violations of the Investment Company Act of 1940.

2. Whether the violations of the Act here charged are a proper basis for asserting liability.

STATUTE INVOLVED

The pertinent provisions of the Investment Company Act of 1940, 15 U.S.C. 80a–1, *et seq.*, are set forth in the Appendix, *infra*, pp. 45–52.[1]

STATEMENT

This is an action for damages and an accounting brought in the United States District Court for the Eastern District of Missouri by the petitioner ("the Fund"), an open-end registered investment company.[2] The suit is based on alleged violations of the Investment Company Act of 1940 ("the Act"). The defendants are present and former directors of the Fund (seven of whom—the so-called "outside direc-

[1] The Investment Company Act is contained in Section 80a of Title 15 of the United States Code. The numbering of the first 28 sections of the Act is the same in both the Act and the Code. Section 29 of the Act, however, was an amendment of the Bankruptcy Act, and does not appear in this portion of the Code. Beginning with Section 30 of the Act, therefore the section numbers in the Code are one number lower than in the Act. For example, Section 36 of the Act is Section 80a–35 of the Code.

[2] Section 5(a)(1) of the Investment Company Act of 1940 defines an open-end investment company as "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer." Such companies are commonly referred to as "mutual funds."

tors"[3]—are the respondents before this Court); the investment adviser of the Fund (Slayton Associates, Inc.) and its two principals, Hilton and Hovey Slayton; and members and employees of a stock brokerage firm (Model, Roland and Stone) (R. 2–3).

The principal charges in the amended complaint (R. 1–12) were: (1) The defendants caused the Fund to pay substantial fees to an investment adviser whose contract had not been authorized by the Fund's shareholders, while at the same time paying more than $1,000,000 to another investment adviser who rendered no services. (This violated Section 15(a) of the Act, see *infra*, pp. 40–41.) (2) Although the stated policy of the Fund was to seek capital growth, the defendants instead followed a policy of making predetermined periodic distributions to its shareholders. (This violated Section 13(a)(3), see *infra*, p. 41.) The latter policy resulted in excessive purchases and sales of securities, which produced large commissions for the Fund's brokers at the expense of the Fund's securities portfolio. The complaint alleged (R. 3) that all of the "outside directors" had actual or constructive knowledge of the violations charged.

More specifically, the pertinent allegations of the amended complaint—and of the complaint in a stockholder's derivative action based on the same conduct (R. 12–20), which was consolidated in the district

[3] Section 10(a) of the Act provides that no more than 60 per cent of the Board of Directors of a registered investment company shall be investment advisers of, affiliated persons of an investment adviser of, or officers or employees of, such investment company. Only the seven "outside directors" appealed to the court of appeals. See *infra*, p. 6.

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court with the instant case (R. 28, 40)[4]—are as follows:

By contract dated August 15, 1952, the Fund employed Slayton Associates as its investment adviser, at an annual fee of one half of one per cent of the value of the Fund's assets (R. 4, 14–15). On December 1, 1953, Slayton Associates employed defendant Jaquith as investment counsellor and manager of the Fund's securities portfolio, at an annual fee of $50,000 for the first five years and a minimum of $35,000 a year for the next five years, to be paid through brokerage on the Fund's portfolio transactions (R. 5, 15). Under its investment advisory contract with the Fund, Slayton Associates was paid total fees of more than $1,000,000 over a six-year period, for which it performed no services (R. 5, 15–16). While receiving such fees, it "unlawfully delegated its duties thereunder to defendant Jaquith and abdicated its duties and responsibilities" thereunder (R. 5.)

Pursuant to his contract with Slayton Associates, Jaquith channeled the Fund's brokerage business to Model, Roland and Stone, a firm with which he was first associated and in which he later became a partner (R. 3, 5). Model, Roland and Stone received

[4] A stockholder's action was filed by one Josephson in the United States District Court for the District of Delaware (R. 13), shortly before the Fund filed its original complaint. The *Josephson* action was transferred to the Eastern District of Missouri. The Protective Casualty Insurance Company subsequently intervened in the case as a party plaintiff and adopted the *Josephson* complaint (R. 38, 42, 45). We shall treat the consolidated cases as a single case, and refer to the two complaints as "the complaint."

brokerage commissions on this business of more than $1,500,000 (R. 5). The defendants Smith and Stubbs (both of whom were employed by Model, Roland and Stone at the direction of Slayton Associates, one of whom was a former business associate of the Slaytons, and the other of whom was a brother-in-law of one of the Slaytons) shared in these brokerage commissions to the extent of more than $50,000 a year each, but performed no services for such payments (R. 3, 5, 15–16).

The Fund's investment policy, as announced in its prospectuses and in its registration statement filed with the Securities and Exchange Commission, was primarily to provide for capital growth, and to seek reasonable income consistent with that aim (R. 4). After the execution of the investment service contract between Jaquith and Slayton Associates, however, this policy was not followed. Instead, the Fund followed a policy of maintaining a predetermined amount of distributions on its shares from year to year. Since the income from the Fund's investments was not sufficient to make such distributions, the Fund had to realize gains through the sale of its securities (R. 5–6). This led to an increased number of purchases and sales by the Fund, which in turn produced greater fees for Jaquith and his partners in Model, Roland and Stone (R. 6, 16). This policy "resulted in gross mismanagement of, and loss and damage to, the investment portfolio" of the Fund (R. 6).

As a result of the foregoing operating changes, the registration statements, prospectuses and reports filed by the Fund with the Securities and Exchange Com-

mission contained false statements, which may lead to possible liability to investors (R. 7–8). In addition, the Fund was injured as a result of stop-order proceedings brought against it by the Commission because of the false statements (R. 8).

Pursuant to a conspiracy, Slayton Associates, Jaquith, and Model, Roland and Stone breached their fiduciary relationship with the Fund through mismanagement and waste of the Fund's assets (R. 9–10, 19). The Fund was operated and managed, and its portfolio securities were selected, in the interest of its directors, officers, investment advisers, other affiliated persons, and its underwriters, brokers and dealers, "rather than in the interest of all classes of [its] securityholders" (R. 6–7). The "outside directors" had knowledge both of the fiduciary relationship of the other defendants to the Fund, and of such defendants' mismanagement and waste, but failed to take any action to prevent it (R. 10–11).

All the defendants moved to dismiss on various grounds (R. 21–28), including the claim that the Act "does not confer jurisdiction on this Court of the claims attempted to be averred" (R. 21). The district court denied the motions without opinion (R. 28–30).

Upon appeal under the interlocutory appeals statute (28 U.S.C. 1292(b)) by the seven "outside directors," the Court of Appeals for the Eighth Circuit reversed, and directed dismissal of the complaint as to those defendants (R. 40–71). Pointing out that there is no "specific language [in the Act] creating civil liability respecting private actions," the court held that di-

rectors' liability to registered investment companies which they serve has not been created by implication (R. 49).

The court stated (R. 59) that the legislative history of the Act "afforded little assistance either in justifying or refuting the implication of a private right of suit such as claimed here." It ruled (R. 60), however, that the "failure [of Congress] to provide for any private civil remedies or for joint and several liability of directors and persons who commit or contribute to violations or for statutes of limitations or for conditions is persuasive that the omission was deliberate"; and that "[t]he enactments as they stand do not justify implications that jurisdiction was intended to be conferred." The court concluded (R. 71):

> * * * The complaints here substantially seek to hold these former directors to strict liability as insurers. The Act they rely on not only contains no such provision but plainly negates any intent to create such an innovation. The reliance upon implication to support the jurisdiction is not justified in the face of the legislative intent to exclude it.

SUMMARY OF ARGUMENT

I

The principal issue in this case is whether a registered investment company can maintain an action for damages and for an accounting against its directors, based on their violations of the Investment Company Act. While the Act does not expressly authorize such

an action, it should be permitted under the settled rule that where a "disregard of the command of the statute * * * results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied * * *" (*Texas & Pacific Ry.* v. *Rigsby*, 241 U.S. 33, 39). The complaint charged that all the defendants, including the directors, had violated the Act by operating the Fund in the interest of insiders rather than of investors. The Act was intended to protect investors from such mismanagement and, in order to make such protection effective, a private right of action by the company to recover damages for the statutory violations should be implied.

A. The doctrine of implied liability for statutory violations has been applied by the federal courts in a wide variety of situations to give private litigants a remedy for the violation of federal rights, where the statute creating such rights does not expressly provide for private enforcement. A private right of action will be implied when it will effectuate the basic design and policy of the legislation by redressing loss by the persons injured by the violation; and it will be implied for violation of particular statutory provisions even though private actions are expressly provided for violations of other sections of the same act. Since the theory of such an action is that it must be *implied* to effectuate the statutory design, it will not be defeated by the lack of *express* support therefor in the legislative history. Thus, where a private right of action appears necessary and appropriate to

implement a statute, it will be implied unless Congress affirmatively indicated an intention to bar such action—as it would by giving the government exclusive authority to enforce the statute.

B. Effectuation of the basic design of the Investment Company Act requires that a private right of action be implied for statutory violations. The Act was passed as the result of an extensive investigation by the Securities and Exchange Commission which disclosed a wide variety of improper practices by investment company managements which had seriously injured investors in such companies. Among the specific improper practices which Congress declared it was the policy of the Act to eliminate were the management of investment companies in the interests of insiders rather than of security holders; the management of such companies by irresponsible persons; and the change in the character of the business without the consent of security holders (Sections 1(b)(2), 1(b)(4), 1(b)(6)).

In order to eliminate and prevent the abuses that had been disclosed, Congress enacted a broad regulatory statute which governs in detail the organization, management and operation of investment companies. Congress carefully specified the duties and obligations of persons who, through their participation in, and affiliation with, investment company management and operation, control the vast assets possessed by these companies. Numerous provisions of the Act not only regulate the practices of the companies, but also impose specific prohibitions and duties upon directors.

Since Congress has provided these intricate and

detailed provisions for the protection of the shareholders in investment companies, it is natural to infer that Congress intended these statutory rights to be enforced by the very persons for whose benefit they were created. For the courts consistently imply a private right of action in favor of those whose interest the legislation was designed to protect. Furthermore, such a private right of action should exist not only in favor of the shareholders individually, but also in favor of shareholders collectively, *i.e.*, the investment company itself.

As the court of appeals recognized (R. 59), the legislative history of the Investment Company Act is silent on whether investment companies and their shareholders can maintain private actions for violation of the Act. Under the settled principles governing liability for violation of statutory duties, however, the right to bring such an action will be implied unless there is some affirmative indication that Congress did not intend it. There is no such indication here. On the contrary, the clear indication in the legislative history that Congress intended to take all steps necessary to protect investors against the serious abuses that had developed in the investment company industry is persuasive support for the implication of private actions designed to further that obective.

The fact that in other statutes Congress has sometimes specifically made directors liable for statutory violations is no basis for rejecting such implication here. If that contention were sound, there could never be any implied right of action for violation of a federal statute, since it could always be argued that if

Congress intended to impose liability it would have expressly done so. Nor do the statutory provisions authorizing the Commission to seek injunctive relief and imposing criminal penalties for willful violations, obviate the need for private actions to restore the losses suffered by the victims of the statutory violations.

C. The conclusion that a private right of action exists for violations of the Investment Act is supported not only by the general design of the Act and its legislative history, but by various specific statutory provisions which imply, although they do not expressly provide for, such actions. For example, Section 44 gives district and state courts concurrent jurisdiction of "all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of," the Act. The present suit, in which the Fund seeks recovery of the damages which it suffered from the defendants' violations of various duties and prohibitions that the Act imposes upon them, is one to "enforce [a] liability or duty created by" the Act. Section 47(b), which provides that contracts in violation of the Act are void, would be of little effect unless the victims of such illegal contracts have the right to obtain relief therefrom and to recover damages caused thereby. See also, Section 17(h), which prohibits the exculpation of any investment company director or officer from any liability to the company or its security holders to which he would otherwise be subject by reason of certain kinds of misconduct; and Section 38(c), which provides that no provision of the Act "imposing any liability" shall apply to any act

done or omitted in good faith in conformity with any Commission rule, regulation or order that may later be found invalid.

D. The existence of a private right of action for violation of the Investment Company Act is further supported by the almost unanimous weight of judicial authority, which has upheld such actions both under that Act and under other federal securities acts. With the exception of the decision below, every federal court that has considered the question has recognized that a private right of action exists for violation of the Investment Company Act. In addition, private rights of action have been consistently recognized for violation of the Securities Exchange Act of 1934 and the Securities Act of 1933. In view of the broad extent to which private remedies have been recognized for violations of the latter statutes, it would indeed be strange if such remedies do not also exist for violations of the Investment Company Act, which provides far more comprehensive protection to shareholders than the former Acts.

II

The complaint properly alleges, on behalf of the Fund, a liability against the directors based on their violations of the Act.

A. The acts charged against the defendants in this case violated specific provisions of the Act. The allegation that Slayton Associates employed Jaquith as the Fund's investment adviser, and thus in effect assigned its investment advisory contract with the Fund to Jaquith, charged a violation of Section 15(a), which prohibits a person from serving as an invest-

ment adviser of a registered company except pursuant to a written contract approved by a majority of the shareholders. The allegation that the Fund departed from its basic policy of providing for capital growth (and, instead, followed a policy of making predetermined annual distributions that were not earned and could only be paid by selling portfolio securities to produce capital gains), charged a violation of Section 13(a)(3), which prohibits any registered company from deviating from any fundamental policy recited in its registration statement, except upon the affirmative vote of a majority of its outstanding voting shares. These two statutory violations were particularly serious because they facilitated the practices which allegedly permitted the insiders to profit at the expense, and to the detriment, of the Fund and its shareholders—namely, the making of substantial payments to Slayton Associates for which no services were rendered; and the "churning" of the Fund's portfolio securities, which produced substantial commissions for Jaquith and other members of his brokerage firm. While the particular statutory provisions which the respondents are alleged to have violated do not, in terms, specifically apply to directors, all of the statutory prohibitions and obligations that the Act imposes upon registered investment companies necessarily also apply to the directors who govern the company. The complaint in this case, therefore, charges that the directors have breached their statutory fiduciary obligations toward the Fund by participating in the illegal acts alleged.

B. The court of appeals erred in concluding (R. 71) that the complaint sought to hold the seven independent directors liable as insurers. The complaint alleged (R. 6–7) that "the defendants committed, or with actual or constructive knowledge * * * aided, abetted, acquiesced in or condoned" specific violations of the Act; and that the seven independent directors had actual or constructive knowledge of the acts charged (R. 2–3, 11–12). The complaint thus charged that the independent directors had personally and knowingly participated in the statutory violations.

ARGUMENT

I

A REGISTERED INVESTMENT COMPANY HAS AN IMPLIED RIGHT OF ACTION FOR DAMAGES AGAINST ITS DIRECTORS FOR THEIR VIOLATION OF THE INVESTMENT COMPANY ACT OF 1940

The principal issue in this case is whether a registered investment company can maintain an action for damages and an accounting against its directors, based on their violations of the Investment Company Act. The Act does not expressly authorize such a private suit, and the court of appeals held (R. 49) that "directors' liability to registered investment companies which they serve" has not been created "by implication," since the language of the Act, as well as its legislative history, "shows that it was the legislative intent to refrain from entering the field of director responsibility" (R. 68).[5]

[5] As we show below (pp. 23–24), Congress did "enter * * * the field" of "director responsibility."

This holding is contrary to the general rule that if the purpose of a statute is to protect a particular segment of society, a violation will result not only in the imposition of the sanctions provided by the statute, but also in a right of recovery in favor of those persons in the protected group who have suffered from the unlawful act. It is well settled that

> A disregard of the command of the statute is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied * * *. [*Texas & Pacific Ry.* v. *Rigsby,* 241 U.S. 33, 39.]

Accord: *Fairport P. & E. R. Co.* v. *Meredith,* 292 U.S. 589, 596–597; Restatement, Torts, Sec. 286. See, also, *Bell* v. *Hood,* 327 U.S. 678, 684 ("* * * where federally protected rights have been invaded, it has been the rule from the beginning that courts will be alert to adjust their remedies so as to grant the necessary relief").

The complaint in this case charged that all the defendants, including the directors of the Fund, had committed serious violations of the Act; and that such violations had substantially damaged the Fund (see the Statement, *supra,* pp. 3–6). The structure and the history of the Act show that it was intended to protect investors from the precise type of violation here charged—the operation of an investment company in the interest of insiders rather than of investors. In order to make such protection effective, a private right of action to recover damages for the

statutory violations should be implied. This conclusion is also supported by many lower court cases, which have consistently upheld the right to maintain private actions for violations not only of the Investment Company Act but also of other federal securities legislation administered by the Securities and Exchange Commission.

A. THE DOCTRINE OF IMPLIED LIABILITY

The doctrine of implied liability has been applied by the federal courts in a wide variety of situations to give private litigants a remedy for the violation of federal rights, where the statute creating such rights does not expressly provide for private enforcement.[6] A private right of action will be implied when it will effectuate the basic design and policy of the legislation by redressing loss by the persons injured by the violation; and it will be implied for violation of particular statutory provisions even though private actions are expressly provided for violation of other sections of the same act. See *infra*, pp. 26–27, 35–36. Moreover, since such rights of action are implied, they "are not contingent upon statutory language which affirmatively indicates that they are intended. On the contrary, they are implied unless the legislation evidences a contrary intention." *Brown* v. *Bullock*, 194 F. Supp. 207, 224 (S.D. N.Y.), appeal pending, C.A. 2, No.

[6] *E.g.*, *Tunstall* v. *Brotherhood of Locomotive Firemen*, 323 U.S. 210, 213 (Railway Labor Act); *Fitzgerald* v. *Pan American Airways, Inc.*, 229 F. 2d 499, 501 (C.A. 2) (Civil Aeronautics Act of 1938); *Reitmeister* v. *Reitmeister*, 162 F. 2d 691, 694 (C.A. 2) (Communications Act of 1934). See also the cases cited *supra*, p. 15.

26948; see *Narramore* v. *Cleveland, C., C. and St. L. R. Co.*, 96 Fed. 298, 300 (C.A. 6), certiorari denied, 175 U.S. 724; *Taussig* v. *Wellington Fund*, 187 F. Supp. 179, 217–219 (D. Del.)

The concept of implied liability is an outgrowth of the torts principle that violation of a statutory duty constitutes negligence toward the person for whose benefit the duty was created. Restatement, Torts, Sec. 286, see 2 Loss, *Securities Regulation* (2d ed., 1961), pp. 934–937. In the securities field, additional bases for implying a private right of action have been the statutory provisions declaring that contracts in violation of the act are void (see *Goldstein* v. *Groesbeck*, 142 F. 2d 422 (C.A. 2), certiorari denied, 323 U.S. 737; *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa.)), and granting the district courts jurisdiction of actions brought to enforce any duty or liability created by the act (*Remar* v. *Clayton Securities Corp.*, 81 F. Supp. 1014, 1017–1018 (D. Mass.); see *infra*, pp. 34–39).

Furthermore, since the theory of such an action is that it must be implied to effectuate the statutory design, it will not be defeated by the lack of express support in the legislative history. The principal significance of legislative history, therefore, is to ascertain whether Congress negated the existence of such implied private actions, either explicitly, or implicitly by giving the government the exclusive authority to enforce the statute. See *Amalgamated Workers* v. *Edison Co.*, 309 U.S. 261, 267–269; *Consolidated Freightways* v. *United Truck Lines*, 216 F. 2d 543 (C.A. 9), certiorari denied, 349 U.S 905. As we show

below (pp. 18–21, 24–26), the legislative history, although not dealing expressly with this question, does justify implied liability; in any event, it clearly does not negate it.

B. EFFECTUATION OF THE BASIC DESIGN OF THE ACT REQUIRES THAT A PRIVATE RIGHT OF ACTION BE IMPLIED FOR STATUTORY VIOLATIONS

1. The Investment Company Act is a comprehensive regulatory statute which governs in detail the organization, management and operation of investment companies. It resulted from an extensive investigation by the Securities and Exchange Commission, followed by lengthy congressional hearings, which disclosed a wide variety of improper practices by investment company managements that had seriously injured investors in such companies. The conditions that permitted such improprieties were explained by the Senate Committee as follows (S. Rep. No. 1775, 76th Cong, 3d Sess., p. 6):

> Basically the problems flow from the very nature of the assets of investment companies. The assets of such companies invariably consist of cash and securities, assets which are completely liquid, mobile and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploitation by the unscrupulous managements of some companies. These assets can and have been easily misappropriated and diverted by such types of managements, and have been employed to foster their personal interests rather than the interests of public security holders. It is obvious that in the absence of regulatory legisla-

> tion, individuals who lack integrity will continue to be attracted by the opportunities for personal profit available in the control of the liquid assets of investment companies and that deficiencies which have occurred in the past will continue to occur in the future.

With respect to the major improprieties here charged—the change of investment advisers and of the Fund's basic investment policy, made without the consent of the shareholders (see the Statement, *supra*, pp. 3–5)—the Committee stated (*id.*, p. 7):

> A major problem in the case of management companies is created by the absence of any legal requirement for adherence to any announced investment policies or purposes. Such policies have often been radically changed without the knowledge or prior consent of stockholders. Similarly, after investors have invested in companies on their faith in the reputation and standing of the existing managements, control of the public's funds has frequently been transferred without the prior knowledge or consent of stockholders to other persons who were subsequently guilty of gross mismanagement of the companies.

The Committee further stated (*id.*, p. 11) that "[t]he conclusion is clear that the perpetrations of these misfeasances and the recurrence of these abuses cannot be completely abated nor the deficiencies eliminated without the enactment of adequate Federal legislation regulating these institutions." It pointed out (*id.*, p. 12) that representatives of the investment

company industry "recognized that the protection of investors against unscrupulous management and the necessity for the prevention of the recurrence of the abuses disclosed by the Commission's study and the committee hearings made indispensable the immediate enactment of adequate legislation regulating investment companies"; and that such representatives "urged that this legislation will serve the most salutary purpose of protecting small investors from breaches of trust; will afford investors a regulated and supervised institution in which to invest their savings * * *. The industry asserted, and the Commission and the committee believe, that this legislation will tend to prevent those abuses which have been a stigma upon and impaired the usefulness of the investment trust industry as a whole."

The House Committee made a similar explanation of the reasons for, and the aims of, the legislation. H. Rep. No. 2639, 76th Cong., 3d Sess., pp. 7–9.

In Section 1(b) of the Act, Congress declared that "the national public interest and the interest of investors are adversely affected"

* * * * *

> (2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers * * * or other affiliated persons thereof * * * [or] of underwriters, brokers, or dealers * * * rather than in the interest of * * * such companies' security holders;

* * * * *

> (4) * * * when investment companies are managed by irresponsible persons;
>
> * * * * *
>
> (6) when investment companies * * * change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders * * *.

Congress further stated (*ibid.*) that it is the "policy and purposes" of the Act "to mitigate and, as far as feasible, to eliminate" the various specified abuses; and that the provisions of the Act "shall be interpreted" in accordance with such policy and purposes.

2. In order to eliminate and prevent the serious abuses by investment companies that had been disclosed, Congress enacted broad regulatory legislation. The Act went far beyond the earlier federal securities acts, which were primarily disclosure statutes, since Congress concluded that mere disclosure legislation would not provide adequate protection to investment company shareholders. See S. Rep. No. 1775, 76th Cong., 3d Sess., pp. 11–12; H. Rep. No. 2639, 76th Cong., 3d Sess., p. 10. Congress provided for detailed regulation of virtually all aspects of the investment company industry. It carefully specified the duties and obligations of persons who, through their participation in and affiliation with investment company management and operation, control the vast assets possessed by these companies.

The Act requires that investment companies register with the Commission, and prohibits interstate transactions by unregistered companies (Sections 8 and 7).

Specific requirements are imposed for the corporate and capital structures of registered investment companies (Section 18), and various transactions between registered companies and their affiliates and underwriters are prohibited except with Commission approval (Section 17). Limitations are imposed upon the payment of dividends (Section 19) and upon the solicitation of proxies (Section 20(a)), and the sale of voting trust certificates is prohibited (Section 20(b)). Unless authorized by the holders of a majority of its outstanding shares, a registered investment company cannot deviate from any fundamental policy recited in its registration statement filed with the Commission (Section 13(a)(3)).

Restrictions are placed upon the purchase and sale of portfolio securities by investment companies (Section 12), and upon the distribution and repurchase of their own shares (Sections 22, 23). The Act makes it unlawful for any person to serve as an investment adviser of a registered company, except pursuant to a written contract that has been approved by a majority of the company's outstanding voting shares (Section 15(a)). To be valid, such an investment advisory contract must provide for its automatic termination if it is assigned by the investment adviser (Section (15(a)(4)). There are also provisions which govern the standards and procedures for reorganization of investment companies (Section 25); require the filing with the Commission, and the transmittal to stockholders, of various reports by registered companies (Section 30); provide for the maintenance of accounts and records (Section 31); and give the stockholders

control over the selection of accountants and auditors (Section 32). Larceny and embezzlement from a registered investment company are made federal crimes (Section 37).

In addition to the provisions which regulate the practices of investment companies generally, the Act also deals specifically with directors. For example, Section 10 requires that at least 40 percent of the directors be unaffiliated with the investment adviser of the investment company, and that at least 50 percent be unaffiliated with the principal underwriter. (The respondents before this Court are the Fund's unaffiliated or "independent" directors.) Section 30(f) bars certain "insiders" of registered closed-end investment companies, including directors, from profiting on purchases and sales of their company's equity securities made within a six-month period. Section 36 authorizes the Commission to bring an action for gross misconduct or gross abuse of trust against, among others, directors of registered investment companies; and, if such allegations are established, directs the court to enjoin such persons, either permanently or temporarily, from acting in such capacity. In addition, all of the restrictions which the Act imposes upon "affiliates" of registered investment companies in their dealings with such companies (*e.g.*, Sections 17, 32(a)(1)) are applicable to directors, since Section 2(a)(3)(D) defines "affiliated person" to include director.

The court of appeals was thus plainly in error in ruling (R. 68) that "it was the legislative intent to refrain from entering the field of director responsi-

bility." Congressional concern with insuring the highest standards of "director responsibility" is manifest not only from the face of the statute, but from the numerous references in the Committee reports to the duties of, and the disabilities being imposed upon, directors of registered investment companies. S. Rep. No. 1775, 76th Cong., 3d sess., pp. 7, 14, 15; H. Rep. No. 2639, 76th Cong., 3d Sess., pp. 9, 14, 17, 18. Furthermore, the various statutory provisions governing the conduct of investment companies also impose upon the directors the duty of compliance therewith. See *infra*, p. 41.

3. Since Congress has provided these intricate and detailed provisions for the protection of the shareholders in investment companies, it is natural to infer that Congress intended these statutory rights to be enforced by the very persons for whose benefit they were created. As the court stated in *Goldstein* v. *Groesbeck*, 142 F. 2d 422, 427 (C.A. 2), certiorari denied, 323 U.S. 737, in holding that there was a right of action by stockholders of a registered holding company for violations of the Public Utility Holding Company Act of 1935:

> [A] denial of a private right of action to those for whose ultimate protection the legislation is intended leaves legislation highly publicized as in the public interest in fact sadly wanting, and even delusive, to that end.

Similarly, in *Brown* v. *Bullock*, 194 F. Supp. 207, 246 (S.D. N.Y.), pending on appeal, C.A. 2, No. 26948, the court, in holding that there is a federal private right of action for damages based on conduct by in-

vestment company officers, directors and affiliates which constituted a "gross abuse of trust" within the meaning of Section 36 of the Act, stated:

> The indifference to federal civil liability for "gross misconduct or gross abuse of trust" attributed by defendants to Congress cannot be reconciled with the emphatically expressed purpose of Congress to eliminate those very evils and to protect investors against those very abuses.

There is, of course, a means by which the law avoids such an anomalous result. Where a statute does not give those whose interest it was designed to protect the express right to maintain an action to vindicate their rights, the courts consistently imply the right of action. See *supra,* pp. 14–17.

A private right of action for violation of the Investment Company Act is necessary to give investors the full measure of the protection which Congress provided for them. Of course, the Act gives the Commission broad enforcement authority,[7] and provides criminal penalties.[8] But such provisions can, at

[7] Section 42(e) authorizes the Commission to bring proceedings in the district court to enjoin "any act or practice constituting a violation of any provision" of the Act or of any Commission rule, regulation or order, and authorizes permanent or temporary injunctive relief. In addition, Section 36 contains special provisions governing the granting of injunctive relief in cases of gross mismanagement or gross abuse of trust by certain investment company personnel and affiliates. See *supra*, p. 23.

[8] Section 49 imposes criminal penalties for willful violations of the Act or of any Commission rule, regulation or order, and for willful misstatements in any document which the Act requires to be filed or transmitted.

best, accomplish only the termination of existing violations and the prevention and deterrence of future wrongs. They cannot restore the losses that the shareholders have already suffered from the violations. Those losses can be recovered only through a private action in which the violators will be required to make the victims whole. Such a private action is thus necessary to achieve fully "the protection of investors against unscrupulous management" (S. Rep. No. 1775, 76th Cong., 3d Sess., p. 12) which Congress sought to provide; it also serves the salutary purpose of imposing an additional sanction that will tend to deter violations.

Furthermore, a private right of action against directors who violate the Act should exist not only in favor of the shareholders, but also in favor of the investment company itself. The reason for permitting a private action is that it will effectuate the basic purpose of the Act of protecting shareholders in investment companies from mismanagement. That objective is fully achieved when the malefactors are required to account to the stockholders collectively, *i.e.*, the company, for the injuries they have inflicted by their statutory violations.

4. Both the court of appeals (R. 57) and the respondents (Br. in opp., for respondents *Brouk, et al.*, p. 11) state that where Congress intends to impose director liability, it specifically so provides. They cite a provision of the National Bank Act which authorizes private actions against directors who knowingly violate or permit violations of that Act (12 U.S.C. 93). If this contention were sound, there could never be any implied right of action for viola-

tion of a federal statute. For it could always be argued that if Congress intended to impose liability, it would have done it expressly.

The argument has been rejected under the 1933 and 1934 Acts, and it should be rejected here. Those statutes specifically provide for civil actions for violation of certain sections. Private actions have been implied, however, for violation of other sections for which no right of action is provided. *Thiele* v. *Shields*, 131 F. Supp. 416 (S.D.N.Y.) (1933 Act); *Fratt* v. *Robinson*, 203 F. 2d 627 (C.A. 9) (1934 Act); *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa.) (1934 Act).

5. As the court of appeals recognized (R. 59), the legislative history of the Investment Company Act is silent on whether investment companies and their shareholders can maintain private actions for violation of the Act. Under the settled principles governing liability for violation of statutory duties, however, the right to bring such an action will be implied unless there is some affirmative indication that Congress intends to preclude it (see *supra*, pp. 16–17). There is no such indication here. Moreover, although the legislative history does not in terms deal with this issue, the clear indication that Congress intended to take whatever steps were necessary to protect investors against the serious abuses that had developed in the industry (see *supra*, pp. 18–21) is persuasive support for the existence of private actions designed to further that objective.

The court of appeals, noting that the Act represented a compromise reached by negotiation between

the Commission and industry representatives, concluded that it was unlikely that the industry would have supported the legislation had it believed that private rights of action for violations of the Act would be implied (R. 60). But the industry representatives themselves recognized the need for stringent regulation to correct and prevent the abuses that had developed. S. Rep. No. 1775, 76th Cong., 3d Sess., p. 7; H. Rep. No. 2639, 76th Cong., 3d Sess., p. 10. Indeed, the industry agreed to far more onerous burdens and restraints than the imposition of civil liability for statutory violations.* The fact that the industry representatives agreed to the Act provides no basis for the claim that Congress intended to bar private rights of action.

C. NUMEROUS PROVISIONS OF THE ACT IMPLY THE EXISTENCE OF PRIVATE DAMAGE SUITS FOR STATUTORY VIOLATIONS

The conclusion that a private right of action exists for violations of the Investment Company Act is supported not only by the general design of the Act and its legislative history, but by various specific provi-

*Thus, an industry spokesman supported the view that larceny and embezzlement from an investment company should be made federal offenses. Hearings on H.R. 10065 Before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives, 76th Cong., 3d Sess., p. 124. The industry also accepted the provision in Section 36 that persons connected with an investment company who were guilty of gross mismanagement or gross abuse of trust would not only be removed from office, but might be permanently enjoined from serving with any investment company. S. Rep. No. 1775, 76th Cong., 3d Sess., pp. 1–2; H. Rep. No. 2639, 76th Cong., 3d Sess., p. 5.

sions which plainly imply, although they do not expressly provide for, such actions.

1. Section 44 of the Act gives the district courts jurisdiction of violations of the Act and, concurrently with state and territorial courts,

> of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of,

the Act. It also specifies the district in which "[a]ny suit or action to enforce any liability or duty created by, or to enjoin any violation of" the Act, may be brought. This provision is substantially identical to the jurisdictional provisions of the Securities Exchange Act of 1934 and the Public Utility Holding Company Act of 1935, under which private rights of action have been repeatedly recognized. See *infra*, pp. 34–39.

As we have shown, the Act imposes numerous specific duties upon directors and other persons connected with investment company managements. The complaint in this case charges all of the defendants, including the independent directors, with serious violations of those statutory duties, and seeks to recover the damages that the Fund suffered thereby. The instant suit is, therefore, one to "enforce [a] liability or duty created by" the Act within the meaning of Section 44, and one whose maintenance in the federal courts appears contemplated by that section.

This conclusion is further supported by the grant of jurisdiction to both federal and state courts to entertain actions both at law and in equity. The only

actions which the Act authorizes the Commission to bring are equity actions, and they may be brought only in the federal courts (Sections 25, 35, 36 and 42). Thus, the jurisdiction of the federal courts to entertain actions at law, and of the state courts to entertain actions both at law and equity, can cover only private actions. While this jurisdiction might be explained on the narrow ground that it covered only the section for the violation of which the Act expressly authorized private suits,[19] it is plainly broad enough also to cover private rights of action for violations of other sections.

2. Section 17(h) prohibits the exculpation of any investment company director or officer from any liability to the company or to its security holders "to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office." Such liability could only be enforced through a private action by the company or its stockholders; and unless such an action were maintainable, there would be no need for a prohibition against exculpation.

[19] Section 30(f) permits recovery from investment company insiders of "short swing" trading profits in equity securities of closed-end investment companies. In 1954 the Act was amended to impose civil liability upon directors and others for misstatements in registration statements filed by investment companies under the Securities Act of 1933 (Section 24(e)(3), 68 Stat. 689).

While it is arguable that this provision was designed merely to prevent exculpation from liability under state law, such a narrow reading seems inconsistent with the broad phrase "the duties involved in the conduct of his office." As we have shown, the Act imposes a wide range of special duties upon officers and directors of registered investment companies, which go far beyond those which state law traditionally imposes upon corporate officers and directors generally. Section 17(h) thus seemingly contemplates the existence of a private right of action against investment company officers and directors based on their "reckless disregard of the duties involved in the conduct of [their] office," *i.e.*, the duties imposed by the Act; and it prohibits exculpation from liability therefor.

3. Section 38(c) provides that no provision of the Act "imposing any liability shall apply to any act done or omitted in good faith" in conformity with any Commission rule, regulation or order that may later be found invalid. Although this provision may have been intended merely to insure that persons who acted in good faith reliance upon a Commission ruling would not thereafter be proceeded against by the Commission for such action, the language is not so restricted. A more persuasive interpretation is that Congress intended that no one would be subjected to "any" liability imposed by the Act for acting in reliance upon Commission approval. Such "liability" includes the liability for statutory violations that is enforced through private rights of action.

4. Section 47(b) provides that contracts made in violation of the Act, or the performance of which will violate the Act, are void. But the mere legislative declaration of such voidance, or the utilization of this provision by an investment company as a defense to an action based upon such contract, would be wholly inadequate to protect investment companies and their shareholders against such illegal contracts. If this provision is to be at all effective, the victim of such an illegal contract must be given the right to obtain relief therefrom and to recover damages for the losses caused thereby. As the court stated in *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa.), in relying upon the similar provision of the Securities Exchange Act of 1934 as a ground for upholding an implied right of action for violations of that Act:

> [A] statutory enactment that a contract of a certain kind shall be void almost necessarily implies a remedy in respect of it. The statute would be of little value unless a party to the contract could apply to the Courts to relieve himself of obligations under it or to escape its consequences.[11]

[11] The court of appeals, in attempting to distinguish this ruling in *Kardon*, stated (R. 52) that, unlike the situation in *Kardon*, none of the independent directors here was a party to either of the investment advisory contracts. But the Fund was a party to the original contract, and was the third-party beneficiary of the contract between Slayton Associates and Jaquith. It is the Fund, and not the independent directors, that is seeking to "apply to the courts to * * * escape its consequences" (*Kardon*, *supra*). In any event, privity of contract is not essential for the implication of a private remedy for statutory violations. At most, "[i]t is an evidentiary fact to be considered in conjunction with other material facts in determining whether the

See, also, *Goldstein* v. *Groesbeck*, *supra*, p. 24, involving a similar contract voiding provision of the Public Utility Holding Company Act of 1935.

D. THE EXISTENCE OF A PRIVATE RIGHT OF ACTION FOR VIOLATION OF THE INVESTMENT COMPANY ACT IS SUPPORTED BY THE ALMOST UNANIMOUS WEIGHT OF JUDICIAL AUTHORITY

The existence of a private right of action for violation of the Investment Company Act is further supported by the almost unanimous weight of judicial authority, which has upheld the existence of such actions both under that Act and under other federal securities acts.

1. *Decisions under the Investment Company Act.* With the exception of the decision below, every federal court that has considered the question has recognized that a private right of action exists for violation of the Investment Company Act. *Breswick & Co.* v. *Briggs*, 136 Supp. 301 (S.D. N.Y.); *Schwartz* v. *Bowman*, 156 F. Supp. 361 (S.D. N.Y.), appeal dismissed *sub nom. Schwartz* v. *Eaton*, 264 F. 2d 195 (C.A. 2); *Cogan* v. *Johnston*, 162 F. Supp. 907 (S.D. N.Y.); *Taussig* v. *Wellington Fund*, 187 F. Supp. 179 (D. Del.); *Brown* v. *Bullock*, 194 F. Supp. 207 (S.D. N.Y.), appeal pending, C.A. 2, No. 26948; see *Brown* v. *Eastern States Corporation*, 181 F. 2d 26, 28 (C.A. 4), certiorari denied, 340 U.S. 864. In a suit based on substantially the same alleged viola-

relationship (such as it is) between the plaintiffs and the defendants and the nature of the particular acts and transactions involve the duty created by the statute" (*Brown* v. *Bullock*, 194 F. Supp. 207, 230 (S.D. N.Y.), pending on appeal, C.A. 2, No. 26948).

tions of the Act as are charged in the instant case, and involving the Fund, a Delaware court recently upheld the existence of a private right of action. *Lutz* v. *Boas*, 171 A. 2d 381 (Del. Ch.). Most of these cases have relied heavily on the decisions sanctioning a right of action under the other federal securities acts.

In the *Schwartz* case, *supra*, the Court of Appeals for the Second Circuit stated (264 F. 2d at 198, n. 5) that it was "clear" that "such remedies [accounting, injunction and damages] may be had [in a private action] under the Investment Company Act."

2. *Decisions under other federal securities acts.* The principal development of the private right of action for violation of federal securities legislation has been under the Securities Exchange Act of 1934 (the "1934 Act"). The right was first recognized in *Baird* v. *Franklin*, 141 F. 2d 238 (C.A. 2), certiorari denied, 323 U.S. 737. There an investor was held entitled to maintain an action against the Treasurer of the New York Stock Exchange to recover damages suffered in the 1938 Richard Whitney scandal. The plaintiff's theory was that she had been injured because of the failure of the exchange to discipline Whitney, as required by Section 6(b) of the 1934 Act. Although the court denied recovery because there was no showing that the failure to discipline was the proximate cause of the plaintiff's damage, it ruled that a private action would lie for the statutory violation. Pointing out that the Act was intended to protect investors and to provide reasonably complete and effective control of secu-

rities transactions (141 F. 2d at 244–245), the court stated (*id.* at 245) that if this statutory purpose was to be achieved, Section 6(b)

> must be construed as granting to injured investors individual causes of action to enforce the statutory duties imposed upon the exchanges.

In the leading case of *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa.), a private right of action was held to exist in favor of a stockholder for violations of the anti-fraud provisions of the 1934 Act (Section 10(b), 15 U.S.C. 78j(b); Rule 10b–5 of the Commission's rules and regulations under the 1934 Act). The court rejected the argument that the fact that the Act specifically authorized private actions for violation of three other sections indicated a Congressional intent to exclude such actions for violation of Section 10(b). It stated (69 F. Supp. at 514):

> * * * Were the whole question one of statutory interpretation it might be convincing, but the question is only partly such. It is whether an intention can be implied to deny a remedy and to wipe out a liability which, normally, by virtue of basic principles of tort law accompanies the doing of the prohibited act. Where, as here, the whole statute discloses a broad purpose to regulate securities transactions of all kinds and, as a part of such regulation, the specific section in question provides for the elimination of all manipulative or deceptive methods in such transactions, the construction contended for by the defendants may not be adopted. In other words, in view of the general purpose of the

> Act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies.

See, also, *Fratt* v. *Robinson*, 203 F. 2d 627, 631–633 (C.A. 9); cf. *Securities and Exchange Commission* v. *Joiner Corp.*, 320 U.S. 344, 350–352.

Since the *Kardon* decision, the existence of a private right of action for violation of the anti-fraud provisions of the 1934 Act has been recognized by every circuit which has considered the question.[12]

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[12] *Ellis* v. *Carter*, 291 F. 2d 270 (C.A. 9); *Matheson* v. *Armbrust*, 284 F. 2d 670 (C.A. 9), certiorari denied, 365 U.S. 870; *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (C.A. 5), certiorari denied, 365 U.S. 814; *Reed* v. *Riddle Airlines*, 266 F. 2d 314, 315 (C.A. 5); *Fratt* v. *Robinson*, 203 F. 2d 627 (C.A. 9); *Errion* v. *Connell*, 236 F. 2d 447 (C.A. 9); *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783 (C.A. 2); *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808 (D. Del.), affirmed, 235 F. 2d 369 (C.A. 3). See *Slavin* v. *Germantown Fire Ins. Co.*, 174 F. 2d 799 (C.A. 3).

Birnbaum v. *Newport Steel Corp.*, 193 F. 2d 461 (C.A. 2), certiorari denied, 343 U.S. 956, was apparently relied on by the court below as authority for the view that "the courts have rejected implication of federal jurisdiction in director liability cases" (R. 53, 57–58). The *Birnbaum* case, however, does not deny the existence of a private right of action for violation of the 1934 Act. The only question in *Birnbaum* was whether the Commission's anti-fraud Rule X–10b–5, which the defendants were alleged to have violated, was "aimed only at 'a fraud perpetrated upon the purchaser or seller' of securities", or whether it also prohibited "breaches of fiduciary duty by corporate insiders resulting in fraud upon those who were not purchasers or sellers" (p. 463). The court held (p. 464) that "Rule X–10b–5 extended protection only to the defrauded purchaser or seller"; and that "[s]ince the complaint failed to allege that any of the plaintiffs fell within either class," the district court had properly dismissed the complaint for failure to state a cause of action.

The decision in the *Birnbaum* case, therefore, involved only the narrow question of the construction of the Commission's

The right to maintain a private action for violation of the provisions of the 1934 Act governing the solicitation of corporate proxies has also been widely recognized. See Loss, *The S.E.C. Proxy Rules in the Courts*, 73 Harv. L. Rev. 1041. With one distinguishable exception,[12] the courts have consistently upheld

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Rule X-10b-5, and the court held only that the rule did not prohibit the particular conduct there challenged. Nothing in the opinion even remotely suggests that a private action for violation of the rule would not lie if brought by a person entitled to its protection (*i.e.*, a defrauded purchaser or seller). The court cast no doubt upon its prior decisions in the *Fischman* case, *supra*, which had permitted a defrauded purchaser to maintain an action for damages based on violations of Section 10b and Rule X-10b-5; or upon the *Baird* case (*supra*, p. 34), which also recognized the existence of a private right of action for violation of the 1934 Act.

The court below also apparently relied (R. 55-56) upon *Downing* v. *Howard*, 162 F. 2d 654 (C.A. 3), certiorari denied, 332 U.S. 818. There the court upheld the dismissal of a private action based upon alleged violations of the Public Utility Holding Company Act of 1935. The ground of decision, however, was not that a private right of action would not be implied for violation of that Act; on the contrary, the court specifically refused to accept the broad contention that "violation of the registration provisions of the statute will never bring about individual liability" (162 F. 2d at 658). The holding of the court in *Downing* was only that the complaint had been properly dismissed because it failed to show that the statutory violations charged had caused the damage alleged. *Id.* at 658-659.

[12] In *Howard* v. *Furst*, 288 F. 2d 790 (C.A. 2), certiorari denied, 353 U.S. 937, the court refused to permit a stockholder to maintain, on behalf of his corporation, a derivative action against the directors. The claim was that, in order to advance their personal interests, the directors had sold all of the company's assets for less than their value; and that the stockholders' approval of such sale was obtained through a proxy statement that was false and misleading, in violation of

such actions.[14] Stockholders have also been held to have the right to sue brokers for losses suffered

Section 14(a) of the 1934 Act and the Commission's proxy rules. The court held (p. 793) that the 1934 Act did not "create any rights whatever in a corporation whose stockholders may be solicited by proxy statements prepared in contravention of the statutory mandate"; it expressly left open, however, "the question of whether and to what extent Section 14(a) may be construed as creating substantive rights in an individual stockholder" (*ibid.*). The court further held (pp. 793–794) that since the substantive claim that the directors had improperly sold corporate property for less than its value depended upon New York law, the case did not "arise under" the laws of the United States merely because it was contended that such illegal sale had been accomplished through a false proxy statement.

The narrow ruling in *Howard* that a corporation (as distinguished from its stockholders) cannot maintain an action based on violations of the proxy provisions of the 1934 Act has been criticized. 2 Loss, *Securities Regulation* (2d ed., 1961), pp. 949–950. In any event, it does not cover the different—and broader—question here involved. The court in *Howard* relied on the legislative history of the 1934 Act, which, in its view, indicated that Congress did not intend to extend the protection of the proxy provisions of that Act to corporations, as distinguished from the individual shareholders. As we have shown, however, numerous provisions of the Investment Company Act, as well as its legislative history, indicate a clear Congressional intent to protect the company as well as its shareholders.

Significantly, the court in *Howard* did not question the general principle, which it previously had recognized (see note 12, *supra*, pp. 36–37), that a private right of action for violation of federal securities legislation will be implied where necessary to effectuate the basic statutory design. As we have shown, that is the situation in the instant case.

[14] *Dann* v. *Studebaker-Packard Corp.*, 288 F. 2d 201 (C.A. 6); *Tate* v. *Sonotone Corp.*, 5 S.E.C. Jud. Dec. 310 (S.D. N.Y.); *Horowitz* v. *Balaban*, 112 F. Supp. 99 (S.D. N.Y.); *Textron* v. *American Woolen Co.*, 122 F. Supp. 305, 308 (D. Mass.); *Weeks* v. *Alpert*, 131 F. Supp. 608 (D. Mass.); *Doyle*

through loans made in violation of the margin requirements under the 1934 Act.[15]

Private rights of action have also been recognized under the Public Utility Holding Company Act of 1935 and the Securities Act of 1933. A stockholder has been permitted to maintain a derivative action for an accounting for profits received under service contracts that violated the Holding Company Act.[16] A private right of action has also been recognized for violation of the proxy provisions of that Act.[17] Recovery was permitted under the anti-fraud provisions of the 1933 Act, which make no provision for private actions, even though other sections of that statute do expressly provide for private damage actions.[18]

In view of the broad extent to which private remedies have been recognized for violations of the Securities Exchange Act of 1934, it would be strange indeed if such remedies do not also exist for violations of the Investment Company Act. For the latter Act

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v. *Milton*, 73 F. Supp. 281, 285 (S.D. N.Y.); *Dunn* v. *Decca Records, Inc.*, 120 F. Supp. 1 (S.D. N.Y.); *Curtis* v. *American Tel. & Tel. Co.*, 124 F. Supp. 197 (S.D. N.Y.); *Rosen* v. *Alleghany Corp.*, 133 F. Supp. 858, 867–869 (S.D. N.Y.); *Mack* v. *Mishkin*, 172 F. Supp. 885, 889 (S.D. N.Y.); *Central Foundry Co.* v. *Gondelman*, 166 F. Supp. 429 (S.D. N.Y.).

[15] *Remar* v. *Clayton Securities Corp.*, 81 F. Supp. 1014 (D. Mass.); *Appel* v. *Levine*, 85 F. Supp. 240 (S.D. N.Y.); *Reader* v. *Hirsch & Co.*, CCH Fed. Securities Law Rep. ¶91044 (S.D. N.Y.).

[16] *Goldstein* v. *Groesbeck*, 142 F. 2d 422 (C.A. 2), certiorari denied, 323 U.S. 737, discussed *supra*, p. 24.

[17] *Phillips* v. *The United Corp.*, 5 S.E.C. Jud. Dec. 445 (S.D. N.Y.).

[18] *Thiele* v. *Shields*, 131 F. Supp. 416 (S.D. N.Y.).

provides far more detailed regulation than either the 1934 Act or the Securities Act of 1933. As we have shown, the Investment Company Act subjects almost every aspect of the industry to specific requirements and prohibitions, designed to protect investment companies and their shareholders from mismanagement (see *supra*, pp. 21–23). If private actions are necessary for the protection of stockholders' rights under the 1934 and 1933 Acts, *a fortiori* they are necessary to effectuate the more comprehensive shareholder protection given by the Investment Company Act.

II

THE COMPLAINT PROPERLY ALLEGES, ON BEHALF OF THE FUND, A LIABILITY AGAINST THE DIRECTORS BASED ON THEIR VIOLATIONS OF THE ACT

A. THE COMPLAINT CHARGES THE DIRECTORS WITH VIOLATING THEIR STATUTORY DUTIES TOWARD THE FUND

In the present case, the conduct with which the defendants are charged violated specific provisions of the Act. The allegation that Slayton Associates employed Jaquith as the Fund's investment adviser, and thus in effect assigned its investment advisory contract with the Fund to Jaquith, charged a violation of Section 15(a), which prohibits a person from serving as an investment adviser of a registered company except pursuant to a written contract approved by a majority of the shareholders. While the shareholders presumably approved the employment of Slayton Associates, they had not approved the employment of Jaquith (R. 7, 16). Indeed, if the investment advisory contract with Slayton Associates was in conformity with the Act, it terminated automatically

upon its assignment to Jaquith (Section 15(a)(4)).

The complaint also alleged that, following the employment of Jaquith as an investment adviser, the Fund departed from its basic policy, set forth in its registration statement, that its primary purpose was to provide for capital growth; and that instead it followed a policy of making predetermined annual distributions, which in fact were not earned and which could be paid only by selling portfolio securities to produce capital gains. These allegations charged a violation of Section 13(a)(3), which prohibits any registered company from deviating from any fundamental policy recited in its registration statement, except upon the affirmative vote of a majority of its outstanding voting securities.

These two statutory violations were particularly serious because they facilitated the practices which allegedly permitted the insiders to profit at the expense and to the detriment of the Fund and its shareholders—namely, the making of substantial payments to Slayton Associates for which no services were rendered; and the "churning" of the Fund's portfolio securities, which produced substantial commissions for Jaquith and the other members of the brokerage firm of Model, Roland & Stone.

The particular statutory provisions which the respondents are alleged to have violated do not, in terms, specifically apply to directors. But it is the directors who govern the company, and the various prohibitions and obligations that the Act imposes upon registered investment companies necessarily also apply to the directors. The complaint in this case, therefore,

charges that the directors have breached their statutory fiduciary obligations toward the Fund by participating in the illegal acts alleged.

B. THE DIRECTORS ARE NOT SOUGHT TO BE HELD AS INSURERS

The court of appeals erred in concluding (R. 71) that the complaint sought recovery from the seven independent directors on the basis of their allegedly "strict liability as insurers." On the contrary, the complaint alleged (R. 6–7) that "the defendants committed, or with actual or constructive knowledge * * * aided, abetted, acquiesced in or condoned," directly or indirectly, the following specific violations of the Act:

> (1) The Fund deviated from a fundamental policy recited in its registration statement, without the authorization of a majority of its voting securities. This violated Section 13(a)(3).
>
> (2) Jaquith and the members of Model, Roland & Stone served as the Fund's investment advisers without a written contract approved by a majority of the Fund's voting securities. This violated Section 15(a).
>
> (3) The Fund published, circulated and filed with the Commission various statements and reports which contained untrue statements. This violated Section 34(b)."

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[11] There is no merit to the contention of the respondents Baker and Shields (see their separate brief in opposition, pp. 4–6) that the decision below is supportable on the alternative ground (not relied on by the court of appeals) that since the complaint also states a cause of action under state law, the case is not one arising under the laws of the United States. As shown in the text, the complaint alleges violation of Sections

In addition to the foregoing violations of specific provisions of the Act, the complaint also alleged that, contrary to the declaration of policy set forth in Section 1(b)(2), the Fund was operated and managed, and its portfolio securities were selected, in the interest of directors, officers, investment advisers and other affiliated persons thereof, and in the interest of underwriters, brokers and dealers, rather than in the interest of all classes of the Fund's security holders.

The complaint further alleged (R. 2–3, 11–12) that the seven independent directors had actual or constructive knowledge of the acts charged.

Insofar as the independent directors are concerned, therefore, the complaint did not seek to hold them liable as insurers, but on the theory that they had personally and knowingly participated in the statutory violations. Whether, upon the trial of this case, the plaintiffs can establish such participation is another question. The critical point, in the present

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13(a)(3), 15(a) and 34(b) of the Act. The complaint accordingly sets forth a case under the laws of the United States, even though the same conduct may also violate state law.

This case is significantly different from *Howard* v. *Furst*, 238 F. 2d 790 (C.A. 2), certiorari denied, 353 U.S. 937, upon which these respondents principally rely. In *Howard* the court held (p. 794) that "every essential element of appellant's case depends upon" state law; and that since the charge of violation of the Securities Exchange Act of 1934 was merely a "collateral" issue, this charge did not convert the case into one arising under federal law. In the instant case, on the other hand, the violation of the Investment Company Act is the gravamen of the complaint; and such violation plainly states a case arising under the laws of the United States. The *Howard* case is discussed *supra*, n. 13, p. 37.

posture of the case, is that the complaint alleges that they did so participate, and thus asserts a liability against them based on their individual violations of the Act.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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AUGUST 1961.

APPENDIX

The Investment Company Act of 1940, 54 Stat. 789. 15 U.S.C. 80a-1, *et seq.*:

FINDINGS AND DECLARATION OF POLICY

SEC. 1. (a) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby found that investment companies are affected with a national public interest in that, among other things—

* * * * *

(5) the activities of such companies, extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders, make difficult, if not impossible, effective State regulation of such companies in the interest of investors.

(b) * * * it is hereby declared that the national public interest and the interest of investors are adversely affected—

* * * * *

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of

business, rather than in the interest of all classes of such companies' security holders;

* * * * *

(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;

* * * * *

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;

* * * * *

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

GENERAL DEFINITIONS

SEC. 2. (a) When used in this title, unless the context otherwise requires—

* * * * *

(3) "Affiliated person" of another person means

* * * * *

(D) any officer, director, partner, copartner, or employee of such other person;

* * * * *

AFFILIATIONS OF DIRECTORS

SEC. 10. (a) After one year from the effective date of this title, no registered investment company shall

have a board of directors more than 60 per centum of the members of which are persons who are investment advisers of, affiliated persons of an investment adviser of, or officers or employees of, such registered company.

CHANGES IN INVESTMENT POLICY

SEC. 13. (a) No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—

* * * * *

(3) deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, or deviate from any fundamental policy recited in its registration statement pursuant to section 8(b)(2); * * *.

INVESTMENT ADVISORY AND UNDERWRITING CONTRACTS

SEC. 15. (a) After one year from the effective date of this title it shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company and—

(1) precisely describes all compensation to be paid thereunder;

(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of di-

rectors or by vote of a majority of the outstanding voting securities of such company;

(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment by the investment adviser.

* * * * *

(c) In addition to the requirements of subsections (a) and (b) it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, except a written agreement which was in effect prior to March 15, 1940, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved (1) by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party, or (2) by the vote of a majority of the outstanding voting securities of such company.

* * * * *

TRANSACTIONS OF CERTAIN AFFILIATED PERSONS AND UNDERWRITERS

SEC. 17.

* * * * *

(h) After one year from the effective date of this title, neither the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any pro-

vision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office.

* * * * *

REGISTRATION OF SECURITIES UNDER SECURITIES ACT OF 1933

SEC. 24.

* * * * *

(e) * * *

(3) For the purposes of section 11 of the Securities Act of 1933, as amended, the effective date of the latest amendment filed pursuant to this subsection or otherwise shall be deemed the effective date of the registration statement with respect to securities sold after such amendment shall have become effective. For the purposes of section 13 of the Securities Act of 1933, as amended, no such security shall be deemed to have been bona fide offered to the public prior to the effective date of the latest amendment filed pursuant to this subsection. Except to the extent the Commission otherwise provides by rules or regulations as appropriate in the public interest or for the protection of investors, no prospectus relating to a security issued by a face-amount certificate company or a redeemable security issued by an open-end management company or unit investment trust which varies for the purposes of subsection (a)(3) of section 10 of the Securities Act of 1933 from the latest prospectus filed as a part of the registration statement shall be deemed to meet the requirements of said section 10 unless filed as part of an amendment to the registration state-

ment under said Act and such amendment has become effective.[1]

DESTRUCTION AND FALSIFICATION OF REPORTS AND RECORDS

SEC. 34. * * *

(b) It shall be unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to this title or the keeping of which is required pursuant to section 31(a). It shall be unlawful for any person so filing, transmitting, or keeping any such document to omit to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading. * * *

RULES, REGULATIONS, AND ORDERS; GENERAL POWERS OF COMMISSION

SEC. 38.

* * * * *

(c) No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or order of the Commission, notwithstanding that such rule, regulation, or order may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

JURISDICTION OF OFFENSES AND SUITS

SEC. 44. The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States

[1] Subsection (e) was added by Public Law No. 577, 83d Congress (68 Stat. 689).

shall have jurisdiction of violations of this title or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of, this title or the rules, regulations, or orders thereunder. . .

* * * * *

Any suit or action to enforce any liability or duty created by, or to enjoin any violation of, this title or rules, regulations, or orders thereunder, may be brought in any such district or in the district wherein the defendant is an inhabitant or transacts business, and process in such cases may be served in any district of which the defendant is an inhabitant or transacts business or wherever the defendant may be found. * * *

VALIDITY OF CONTRACTS

SEC. 47. (a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or with any rule, regulation, or order thereunder shall be void.

(b) Every contract made in violation of any provision of this title or of any rule, regulation, or order thereunder, and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title, or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any

person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, regulation, or order.

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